

Franchise Tax Board**ANALYSIS OF AMENDED BILL**

Author: Ma Analyst: Gail Hall Bill Number: AB 1591
Related Bills: See Legislative History Telephone: 845-6111 Amended Date: April 10, 2007
Attorney: Tommy Leung Sponsor: _____

SUBJECT: Business Income Apportionment/Members Of Apportioning Trade Or Business May Elect To Utilize One Of The Alternative Formulas

SUMMARY

This bill would provide new rules for corporations to assign income to California.

SUMMARY OF PROPOSED AMENDMENTS

The April 10, 2007, amendments added a new rule for calculating a corporation's apportionment formula.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

It appears the purpose of the bill is to encourage corporations to retain existing business, attract new business, and create new jobs by adding an incentive for investing in California.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2007.

POSITION

Pending.

ANALYSIS**FEDERAL/STATE LAW**

The federal method of taxing corporations doing business within and without a state is different from the California method; therefore, federal law is inapplicable.

Board Position:

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Department Director**Date**

Lynette Iwafuchi
for Selvi Stanislaus

5/7/07

California has adopted the Uniform Division of Income for Tax Purposes Act, (UDITPA), with certain modifications, to determine how much of an apportioning taxpayer's total income, which is earned from activities both inside and outside of California, is attributed to California and subject to California franchise or income tax. UDITPA uses an apportionment formula to determine the amount of "business" income attributable to California.¹

The apportionment formula consists of property, payroll, and sales factors. The property factor includes tangible property owned or rented during the taxable year; the payroll factor includes all forms of compensation paid to employees; and the sales factor is double-weighted and generally includes all gross receipts from the sale of tangible and intangible property.

The calculation of the apportionment formula and California business income is illustrated below.

$$\frac{\left(\frac{\text{Average CA Property}}{\text{Average Total Property Everywhere}} + \frac{\text{CA Payroll}}{\text{Total Payroll Everywhere}} + (2 \times \frac{\text{CA Sales}}{\text{Total Sales Everywhere}}) \right)}{4} = \text{California Apportionment Formula}$$

$$\text{California Apportionment Formula} \times \text{Total Business Income} = \text{California Business Income}$$

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been a three-factor apportionment formula consisting of property, payroll, and double-weighted sales (three-factor, double-weighted sales). An exception to this rule exists for taxpayers that derive more than 50% of their gross business receipts from conducting a "qualified business activity." These taxpayers are required to use a three-factor, single-weighted sales, apportionment formula. For this purpose, a qualified business activity is defined as an agricultural, extractive, savings and loan, and banking or financial business activity. In addition, current law requires that once a determination has been made that the apportioning trade or business is involved in a qualified business activity, the entire apportioning trade or business uses the same weighting, regardless of whether the particular entity was involved in a qualified business activity.

State law permits a departure from the standard apportionment provisions only in limited and specific cases,² and recognizes that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions, in which case special apportionment provisions exist for those situations.³

¹ "Business income attributable to California" is a taxpayer's "business income" multiplied by its California apportionment formula. Revenue and Taxation Code (R&TC) section 25120(a) defines "business income" as income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." R&TC section 25120(d) defines "nonbusiness income" as all income other than business income. In general, "business income" is income arising in the normal course of the taxpayer's business or from assets used in the normal course of the taxpayer's business.

² R&TC section 25137.

³ California Code of Regulations (CCR), title 18, Section 25137.

THIS BILL

This bill would create two alternative apportionment methods a corporation may elect to utilize that would deviate from the standard apportionment formulas described under the Current State Law section above.

Alternative #1 – Sales Factor

For each \$250 million of qualified expenditures made by a member of an apportioning trade or business after January 1, 2007, an additional sales factor would be added to the numerator of the apportionment formula and the denominator of the apportionment factor would be increased by one. (See Appendix A for examples illustrating Alternative 1).

- The apportioning trade or business, or a subgroup thereof, must submit and certify with each tax return filed a summary of the qualified expenditures.
- Qualified expenditures shall include all of the following:
 - 1) Capital expenditures for real and tangible personal property located in California.
 - 2) Expenses incurred to acquire, develop, or license intellectual property in California.
 - 3) Research and development expenses incurred in California.
 - 4) Expenses incurred to develop, enhance, or maintain real property and tangible personal property located in California.
 - 5) Capitalized rent paid in California in excess of the prior year.
 - 6) Compensation and benefits paid to employees in California in excess of the prior year.
 - 7) Payments to independent contractors and payroll companies for work performed in California in excess of the prior year.
 - 8) Training costs incurred in California.
 - 9) Costs incurred in providing a basic level of health care to employees in California, as defined in the Knox-Keene Health Care Service Plan Act, in excess of the prior year.
 - 10) Expenditures incurred in connection with funding research at a four-year public or private college or university located in California.

Alternative #2 – Property and Payroll Factor

A corporation may elect to adjust its property and payroll factors as follows:

- Property shall be excluded from the numerator of the property factor if it is in excess of the value of the taxpayer's real and tangible personal property owned or rented and used in California in the base year.
- The amount of compensation paid by a taxpayer that is in excess of the amount of total compensation paid in the state in the base year would be excluded from the numerator of the payroll factor. Compensation in the base year excludes extraordinary events such as deferred compensation payouts or stock option exercises.
- "Base year" is defined as the year immediately preceding the year of election.
- The member of the apportioning trade or business, or a subgroup thereof, must submit and certify with each tax return filed a summary of the new investment made in California.

See Appendix B for examples illustrating Alternative #2.

Other Provisions

- The election for either Alternative #1 or #2 must be made by attaching a statement to the original return and by specifying the method of adjusting the apportionment factor. The election may be terminated either by the taxpayer with the permission of FTB, or by FTB if the taxpayer fails to submit and certify the required information.
- Electing Alternatives #1 or #2 would not be construed to terminate a water's-edge election, or construed to allow a change or adjustment to the water's-edge election.
- FTB shall prescribe rules and regulations to implement the provisions of this bill.
- The provisions of this bill are severable, so that if any provision or its application is held invalid, that invalidity shall not affect other provisions that can still be given effect without the invalidated provision.
- It is the intent of the Legislature that the sales factor used in any special apportionment rules under section 25137 of the Revenue and Taxation Code would still apply and would not be modified by the bill's provisions.

IMPLEMENTATION CONSIDERATIONS

1. The bill provides that property shall be excluded from the numerator of the property factor if it is in excess of the value of the property used in the state in the base year. The department has interpreted this requirement to mean the numerator of the property factor would be zero if the excess requirement is met. If the author meant for only the incremental amount of property over the base year value would be excluded from the numerator of the property factor, amendments should be considered.
2. The bill lacks a definition for "value of the taxpayer's real and tangible personal property owned or rented" (i.e., cost, fair-market value) and "the amount of compensation" relating to the payroll factor. The department would be unable to implement this bill without a definition.
3. It is unclear how the apportionment formula for a combined report (group tax filing) would be calculated when members of the combined group make different elections under the proposed two new apportionment methods. Current law lacks provisions that allow different members of the same apportioning trade or business to utilize different sales factor weighting. The author should consider providing clarity for elections made by members of a combined group.
4. The bill lacks detailed guidelines for FTB to determine when an election is terminated. The author should consider creating an election similar to the water's-edge election that binds the taxpayer to the water's-edge election for seven years, upon the expiration of which would allow the taxpayer to terminate it.
5. The bill appears to grant FTB mandatory legislative rulemaking authority. The author should consider making the grant discretionary and clarify this is legislative rulemaking authority to ensure effective implementation of the provisions of the bill relating to the new elections for calculating the apportionment formula.

6. On page 6, line 8, the bill provides that the entire business income of the group shall be apportioned using a three factor, single-weighted sales factor or a three factor, double-weighted sales factor apportionment formula. This appears to be in conflict with the allowance of subgroups for the proposed alternative apportionment formulas. The author should consider using the same rules for all the methods for determining the apportionment formula or clarify the difference.

TECHNICAL CONSIDERATIONS

The department has identified the following technical considerations. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. On page 3, line 23, it appears "in this state" should be inserted after "compensation paid." If the author meant for the current year's compensation amount to be the amount paid in the state, an amendment is necessary.
2. On page 3, line 38, the author should consider adding "timely filed" before "original return" to avoid unintended tax planning opportunities.
3. On page 5, line 34, there is a reference to "paragraph (4) of subdivision (c), but there is no paragraph (4) of subdivision (c) in the bill. The author should consider deleting lines 34 through 39, on page 5, in order to avoid confusion.
4. On page 6, line 8, the bill provides that the entire business income of the group shall be apportioned using a three factor, single-weighted sales factor or a three factor, double-weighted sales factor apportionment formula. This appears to be in conflict with the allowance of subgroups for the proposed alternative apportionment formulas. The author should consider using the same rules for all the methods for determining the apportionment formula or clarify the difference.

LEGISLATIVE HISTORY

SB 359 (Runner, 2007/2008) would revise the current rules for apportioning business income to allow certain taxpayers an election to use a three-factor, quadruple-weighted sales apportionment formula, remove "extractive business activities" from the definition of a qualified business activity, and add other miscellaneous provisions. SB 359 is currently in the Senate Revenue and Taxation committee.

AB 1037 (Frommer, 2005/2006), as amended on August 7, 2006, would have created a three-factor, quadruple-weighted sales, apportionment formula for certain industries. AB 1037 was held in the Senate Revenue and Taxation Committee.

AB 2590 (Campbell, 2003/2004) and AB 2560 (Vargas, 2001/2002) would have replaced the three-factor, double-weighted sales apportionment formula used by most corporations with a single-factor apportionment formula based solely on sales. Exceptions to using the single-factor formula would have included: (1) taxpayers that had an average of property and payroll in California in excess of sales that did not meet certain employment requirements would use the three-factor, double-weighted sales formula, and (2) taxpayers that derive more than 50% of their gross business receipts from extractive activities could have used either the single-factor sales formula or the three-factor, single-weighted sales formula. AB 2590 and 2560 were held in Assembly Appropriations.

AB 1642 (Harmon, 2001/2002) and SB 1014 (Johnson, 2001/2002) would have changed the apportionment formula used to determine the amount of business income taxable by California to a single-factor apportionment formula based on sales and allowed extractive businesses to choose either the current three-factor formula based on property, payroll, and sales, or use the new single-factor formula. AB 1642 died pursuant to Article IV, Section 10(c) of the Constitution; SB 1014 was returned to the Secretary of Senate pursuant to Joint Rule 56.

OTHER STATES' INFORMATION

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

General research was performed to determine how these other states "weight" the sales factor in their apportionment formula.

Florida and *Massachusetts* generally use a double-weighted sales factor with some exceptions for specialized industries.

Illinois began using the single sales factor for tax years ending on or after December 31, 2000. The single sales factor formula is used by corporations deriving business income from the state, rather than being determined by a corporation's principal business activity code.

Michigan's apportionment formula consists of 5% payroll, 5% property, and 90% sales.

Minnesota's apportionment formula consists of 12.5% property, 12.5% payroll, and 75% sales for tax years beginning before 2007. In 2005, Minnesota enacted legislation to phase in a sales-only formula over an eight-year period beginning in 2007.

New York utilizes a business allocation formula to assign income from business capital to *New York*. For tax year 2006, *New York* will begin the process of phasing in a new, single-factor allocation formula based on in-state receipts. The single-factor allocation formula will be phased-in as follows: (1) for tax year 2006, the business allocation formula will be equal to 20% property, 60% sales, and 20% payroll; (2) for tax year 2007, the business allocation formula will be equal to 10% property, 80% sales, and 10% payroll; and (3) for tax years beginning on or after January 1, 2008, the business allocation formula will consist of 100% sales.

FISCAL IMPACT

The department's costs to administer the amendments cannot be determined until the department's implementation concerns have been resolved. If the department is required to implement subgroups filing combined within a unitary combined group, forms and information systems may need changes.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 1591 Effective for tax years BOA 1/1/2007 Enacted by 6/1/2007			
2007-08	2008-09	2009-10	2010-11
-\$1 Billion	-\$1 Billion	-\$1 Billion	-\$1 Billion

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

It was determined that for every corporation that would benefit from a hyper-weighted sales factor (Alternative 1), it would benefit even more from the second alternative, which results in an elimination of the property factor numerator. Therefore, the focus of this estimate is on Alternative 2.

To estimate the revenue impact of Alternative 2, the impact of allowing all corporations to exclude the numerator of their property factor while keeping the denominator unchanged was estimated. Simulations based on samples of corporation tax returns for the tax years 2003, 2004, and 2005 indicate the impact of Alternative 2 is a revenue loss of approximately \$2.28 billion for the tax year 2007. It is assumed that 50% of all apportioning taxpayers would qualify for Alternative 2, and the estimated revenue impact of this provision is a revenue loss of \$1.14 billion ($\$2.28 \times 0.5 = \1.14 billion), rounded to \$1 billion, in 2007. Because of the size of the revenue loss for this aspect of Alternative 2, the possible revenue impact from a reduction in the payroll factor was disregarded. In addition, this estimate disregards potential changes in taxpayer behavior, such as the potential for a current California nonapportioning corporation to develop nexus with some other state to take advantage of Alternative 2 to exclude property from the numerator of the property factor.

LEGAL IMPACT

This bill would preface whether a taxpayer may use Alternative 1 or 2 based on the level of activity in this state, which could be subject to constitutional challenge under the Commerce Clause of the United States Constitution. Possible constitutional issues found in the bill include the investment of qualified expenditures, property, and payroll in the state.

ARGUMENTS/POLICY CONCERNS

1. The intended effect of encouraging business to expand in California would only apply to apportioning trades or businesses if this bill were adopted. A business located in California that is wholly in-state would receive no benefit from this bill because wholly in-state businesses do not apportion their income.
2. The allowance of sub-grouping could lead to different filing positions on a yearly basis determined solely on whether the tax effect is greater for a member to utilize the base year computation for property or payroll versus the sales factor effect of multiple weighting.
3. The bill includes maintenance costs as qualified costs. This appears to be at odds with the purpose of the bill to expand California business. These costs would already be incurred and are not a new activity of the taxpayer, yet they are treated as such.
4. The value of property test lacks a provision for recapture. A taxpayer could purchase property at the end of the year to meet the test's requirement, and then return the property after the test is met; alternatively, the members of a unitary group could continuously dispose of the same property to each member of their combined reporting group to qualify multiple members for the election utilizing the same property.

LEGISLATIVE STAFF CONTACT

Gail Hall
Franchise Tax Board
(916) 845-6111
gail.hall@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov

APPENDIX A
AB 1591
EXAMPLES OF ALTERNATIVE 1 – SALES FACTOR

SCENARIO A:

Facts

Property Factor = 20%
Payroll Factor = 20%
Sales Factor = 80%
Made \$250 Million of qualified expenditures
Under current law uses a double-weighted sales factor

Apportionment percentage using current law:

$$(\text{Property } 20\% + \text{Payroll } 20\% + \text{Sales } 80\% + 80\%)/4 = \mathbf{50\%}$$

Apportionment percentage using Alternative #1:

$$(\text{Property } 20\% + \text{Payroll } 20\% + \text{Sales } 80\% + 80\% + 80\%)/5 (4 + 1) = \mathbf{56\%}$$

SCENARIO B:

Facts

Property Factor = 80%
Payroll Factor = 80%
Sales Factor = 20%
Made \$250 Million of qualified expenditures
Under current law uses a double-weighted sales factor

Apportionment percentage using current law:

$$(\text{Property } 80\% + \text{Payroll } 80\% + \text{Sales } 20\% + 20\%)/4 = \mathbf{50\%}$$

Apportionment percentage using Alternative #1:

$$(\text{Property } 80\% + \text{Payroll } 80\% + \text{Sales } 20\% + 20\% + 20\%)/5 (4 + 1) = \mathbf{44\%}$$

APPENDIX B
AB 1591
EXAMPLES OF ALTERNATIVE 2 – PROPERTY AND PAYROLL FACTORS

SCENARIO A:

Facts

Base Year Value of Property Used In CA = \$200,000

Base Year Value of CA Payroll = \$100,000

Uses double-weighted sales factor

Property Factor = 20%: Current year value of property equals \$250,000

Payroll Factor Numerator = \$200,000

Payroll Factor Denominator = \$1,000,000

Payroll Factor = 20%

Sales Factor = 80%

Apportionment percentage using current law:

$(\text{Property } 20\% + \text{Payroll } 20\% + \text{Sales } 80\% + \text{Sales } 80\%)/4 = 50\%$

Apportionment percentage using Alternative #2:

$(\text{Property } 0\% + \text{Payroll } \frac{\$200,000 - \$100,000}{\$1,000,000} = 10\% + \text{Sales } 80\% + 80\%)/4 = 42.5\%$

SCENARIO B:

Facts

Base Year Value of Property Used In CA = \$800,000

Base Year Value of CA Payroll = \$800,000

Uses double-weighted sales factor

Property Factor = 80%: Current year value of property equals \$850,000

Payroll Factor Numerator = \$850,000 Payroll Factor Denominator = \$1,000,000

Payroll Factor = 85%

Sales Factor = 20%

Apportionment percentage using current law:

$(\text{Property } 80\% + \text{Payroll } 85\% + \text{Sales } 20\% + \text{Sales } 20\%)/4 = 51.25\%$

Apportionment percentage using Alternative #2:

$(\text{Property } 0\% + \text{Payroll } \frac{\$850,000 - 50,000}{\$1,000,000} = 80\% + \text{Sales } 20\% + 20\%)/4 = 30\%$